IT IS SO ORDERED.

Lawrence S. Walter
United States Bankruptcy Judge

Dated: June 22, 2011

UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION AT DAYTON

In re: JAY A. HARRIS AND LISA A. HARRIS, *Debtors*	Case No. 10-34965 Judge L. S. Walter Chapter 7

DECISION GRANTING UNITED STATES TRUSTEE'S MOTION TO DISMISS BUT ALLOWING TIME FOR DEBTORS TO CONVERT TO CHAPTER 13

The court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157(a) and 1334 and the standing General Order of Reference in this district. This matter is before the court on the Motion of the United States Trustee to Dismiss Pursuant to 11 U.S.C. § 707(b)(3) [Doc. 21] and the Debtors' Response [Doc. 23].

The United States Trustee ("UST") seeks to dismiss the Chapter 7 bankruptcy case of Jay and Lisa Harris (collectively "Debtors") pursuant to 11 U.S.C. § 707(b)(3).

The UST argues that the case constitutes an "abuse" because the Debtors have substantial projected disposable income to pay creditors outside of bankruptcy or within the context of a Chapter 13 case upon conversion. In reaching this conclusion, the UST relies on the availability of funds that the Debtors would like to pay into a voluntary retirement plan through Jay Harris's employment even though the Debtors were not contributing to a retirement plan at the time of their bankruptcy filing. The UST and the Debtors also disagree about whether unsecured creditors could be paid from funds currently budgeted by the Debtors for expenses that the UST deems excessive or inappropriate.

A hearing was held on January 4, 2011 and the parties filed post-hearing briefs which have been reviewed by the court. After considering the evidence and arguments of counsel, the court makes the following determination. Because the Debtors were not contributing to a retirement plan at the time of their bankruptcy petition filing, they may not initiate contributions post-filing in a converted Chapter 13 case. The availability of these funds in addition to the projected disposable income already available would provide a meaningful distribution to unsecured creditors within the context of a hypothetical five-year Chapter 13 plan or outside of bankruptcy. The court concludes that the Debtors' Chapter 7 filing constitutes an "abuse" as that term is used in § 707(b)(3) and requires that the case be dismissed unless the Debtors elect to convert their case to one under Chapter 13.

FINDINGS OF FACT

Debtors filed their voluntary Chapter 7 bankruptcy petition on July 30, 2010 listing $348,944.25 in secured debts, $15,839.00 in unsecured priority debts and

$162,881.60 [1] in unsecured non-priority debts. Although they noted on their petition that their debts were primarily "Consumer/Non-business" in nature, the court does not doubt that the closure of the couple's graphic design business about three and a half years ago precipitated much of their financial difficulties including significant tax debt.

Following the closure, Lisa Harris, a college educated graphic designer, elected to stay home to care for the couple's daughter. Their daughter is now three years old and is listed as a dependent on the Debtors' schedules.

Jay Harris, also a college educated graphic designer, obtained subsequent employment about two and a half years ago with Crown Equipment Corporation where he remains employed. He currently holds a position as a manager of marketing communications. His monthly gross income, calculated from his most recent pay advices (UST Ex. 4), is $9,919.00, or $119,028.00 per year. This gross income amount reflects some recent pay increases Mr. Harris received from his employer to make up for prior pay reductions during the economic downturn that are not reflected in the Debtors' originally filed Schedule I. The Debtors' current monthly deductions, withheld by the employer for taxes, social security, insurance and contributions to a health care flexible spending account, total $3,096.00 per month.[2] However, Jay Harris testified that he has to pay additional city taxes of $184 per month that are not withheld by his employer. On

[1] This amount includes the added claims per Amended Schedule F [Doc. 16].

[2] The court takes these deductions from the Debtors' most recently proposed Schedule I [Doc. 35, Ex. C]. The itemized deductions include $2,572.09 for taxes and social security, $273.65 for insurance and $249.99 for a Healthcare FSA. The UST does have minor variations in its calculation of net monthly income, but, for the most part, they are negligible. Importantly, the UST adds back in $250 in income described as "Healthcare Savings Account Reimbursement Income," based on the Debtors "double dipping" by including the Healthcare FSA amount as a deduction from income and then including the same amount as a medical expense on Schedule J. However, the most recently updated Schedule J [Doc. 35, Ex. D] used by the Debtors to calculate their current budget contains no medical expenses. Consequently, the Debtors are not "double dipping" on these updated schedules so the court believes it is not appropriate to add back in the reimbursement income as suggested by the UST.

the other hand, the Debtors received a yearly tax refund of about $2,300.00[3] which means they are overwithholding approximately $190 per month. Subtracting the withheld amount from the Debtors' gross pay and the additional city taxes while adding in $1,550.00 in income from a rental property and the $190 per month overwithholding results in a calculation of $8,379.00 per month in net income for the Debtors.

The Debtors do not question this calculation of net income but argue that an additional amount, approximately $1,332.50[4], should be deducted as a contribution to Mr. Harris's 401(k) retirement account. At the hearing, Mr. Harris testified that he and his wife had a history of saving for retirement. They began funding their retirement while their graphic design business was in operation, but, when it started to struggle, they depleted their savings in a failed attempt to keep the business alive and pay creditors. When Mr. Harris began working for Crown, he again initiated contributions to a 401(k) account of about 17% which constituted the maximum amount allowed by law. However, in January of 2010, Mr. Harris ceased his contributions amidst financial struggles and a reduction in pay. Mr. Harris has not contributed to his retirement account since January of 2010. Mr. Harris noted that Crown recently restarted a matching program and, thus, if he does not start contributing for his own retirement through the 401(k), he will lose out on the money that his employer would contribute. If a monthly retirement contribution of $1,332.50 is deducted, the Debtors' net monthly income is reduced to $7,046.50.

[3] Debtor Jay Harris testified that he believed that the IRS was keeping the $2,300.00 refund and applying it towards their federal tax debt. Nonetheless, the fact that the overwitholding continues this year must be taken into account by this court and considered disposable income available for creditors.

[4] In their original Schedule I and at the hearing, the Debtors discussed a possible 401(k) deduction totaling $1,332.50. However, they propose a higher 401(k) deduction of $1,487.85 in the Schedule I filed with their post-hearing brief [Doc. 35, Ex. C]. Although the exact amount does not impact the court's ultimate determination, the court will use the amount that was discussed at the hearing.

In order to determine the Debtors' projected disposable income, the court turns next to the Debtors' current expenses. The Debtors propose an itemized budget of their current expenses in an updated Schedule J while the UST proposes a budget that relies, in part, on what an average household of three budgets for expenses [Compare Doc. 35, Ex. D to Doc. 34, Hypothetical Chapter 13 Plan Overviews]. This average budget is based on testimony that the UST elicited from Scott Stout, attorney for the local Chapter 13 Trustee.

Although the UST and the Debtors reach their calculation of monthly expenses in a different manner, the final numbers are remarkably similar. The Debtors' updated Schedule J [Doc. 35, Ex. D] budgets $5,519.67 for their total monthly expenses. Their detailed itemization includes their actual mortgage and car payments, as well as their rental property expenses and budgeted allotments for food, transportation and other items. The budgeted expenses calculated by the UST total $5,456.00 [Doc. 34, Hypothetical Chapter 13 Plan Overviews]. Because the parties' calculations of expenses differ by a negligible $64, the court accepts the more detailed itemized budget proposed by the Debtors. After subtracting out the Debtors' current expenses totaling $5,519.67 from their net income of $7,046.50, the Debtors are left with monthly projected disposable income totaling $1,526.83.

However, the parties provide conflicting views on how two additional items should be handled in the Debtors' budget and a hypothetical Chapter 13 plan. The first item is the Debtors' student loan obligation. Jay Harris testified that the couple owes approximately $62,000 in student loan debt that accrues interest at 9% per annum. Their monthly loan payment is $650, but they had fallen behind on those payments at the time of the hearing. Debtors argue that the $650 monthly payment should be added in to their budgeted expenses because the debt is nondischargeable. The UST argues that it is inappropriate to pay an unsecured debt as a monthly expense regardless of its status as a nondischargeable debt.

The final item on which the parties disagree is the Debtors' tax debt. After the bankruptcy filing, the Debtors received notice of a tax debt related to their former business. They believe that they will be held personally liable for the debt. The tax and "trust fund recovery penalty" that are to be assessed against the Debtors total somewhere between $27,500, a number that Jay Harris testified to at the hearing, and $37,088.40, a number documented in a post-hearing exhibit [Doc. 35, Ex. A]. The Debtors assert that before calculating what unsecured creditors might receive in a hypothetical Chapter 13 case, the court must take into account full payment of this newly discovered priority tax debt in addition to the other secured and priority tax debts listed in their schedules. While the UST questioned whether the Debtors' personal liability for this newly discovered debt has been verified and its amount is accurate, the UST concedes that if verified, any priority tax debt would have to be paid in full through a Chapter 13 plan. If the maximum potential tax debt of $37,088.40 is added to the priority debts listed in the Debtors Schedule E, their total priority tax debts amount to $52,927.40. In addition, the Debtors have secured tax liens listed in Schedule D totaling $28,965.00. Adding these amounts together, the Debtors' total secured and priority tax debts amount to $81,892.40.

CONCLUSIONS OF LAW

Bankruptcy Code Section 707(b) provides that the court may dismiss a bankruptcy case of individual debtors with primarily consumer debts if it finds that "the granting of relief would be an abuse of the provisions of this chapter." 11 U.S.C. § 707(b)(1). In this case, the UST moves for dismissal pursuant to § 707(b)(3)(B)[5] which provides:

> (3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter . . . the court shall consider –
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> . . .
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> > (B) [whether] the totality of the circumstances ... of the debtor's financial situation demonstrates abuse.

11 U.S.C. § 707(b)(3). Prior to 2005, the standard for dismissal under this provision was higher requiring the UST to carry the burden of proving "substantial abuse" by debtors rather than the current "abuse."[6] Although the standard has been lowered, pre-BAPCPA Sixth Circuit case law remains instructive to the determination of whether a debtor's case constitutes an abuse. *In re Phillips*, 417 B.R. 30, 39 (Bankr. S.D. Ohio 2009); *In re Goble*, 401 B.R. 261, 276 (Bankr. S.D. Ohio 2009).

The seminal pre-BAPCPA cases in the Sixth Circuit analyzing § 707(b) are *In re Krohn*, 886 F.2d 123 (6th Cir. 1989) and *In re Behlke*, 358 F.3d 429 (6th Cir. 2004). In *Behlke* and *Krohn*, the Sixth Circuit held that a case should be dismissed if the totality of debtors' circumstances demonstrate a lack of need and provided factors relevant to the court's analysis. Of those factors, the most critical in determining neediness is whether a debtor has the ability to repay debts out of future earnings. *Behlke*, 358 F.3d at 434; *Krohn*, 886 F.2d at 126 (noting that this "factor alone may be sufficient to warrant

[5] The UST noted at the hearing that the presumption of abuse arose in this case pursuant to 11 U.S.C. § 707(b)(2), but the UST declined to pursue dismissal under this separate provision and filed a "Declination Statement" to that effect [Doc. 20]. Consequently, § 707(b)(2) and the Debtors' means test calculations are not at issue.

[6] The standard for dismissal was changed as part of the revisions to the Bankruptcy Code enacted by Congress in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 also known as "BAPCPA."

dismissal”). Other relevant factors include “whether the debtor enjoys a stable source of future income, whether he is eligible for adjustment of his debts through Chapter 13 of the Bankruptcy Code, whether there are state remedies with the potential to ease his financial predicament, the degree of relief obtainable through private negotiations and whether his expenses can be reduced significantly without depriving him of adequate food, clothing, shelter and other necessities.” *Behlke*, 358 F.3d at 434 (quoting *Krohn*, 886 F.2d at 126-27).

In *Behlke*, the Sixth Circuit noted that one way courts determine a debtor’s ability to pay is “to evaluate whether there would be sufficient disposable income to fund a Chapter 13 plan.” 358 F.3d at 435. Post-BAPCPA, a similar “hypothetical Chapter 13” analysis has been adopted by many courts to determine abuse under § 707(b)(3). *Goble*, 401 B.R. at 276. The UST has applied the same analysis in this case. The determination of ability to pay is to be made at the time of the hearing. *Goble*, 401 B.R. at 276.

In this case, the Debtors argue that their current budget, reflected in their updated Schedules I and J, demonstrates that they have only minimal projected disposable income each month to pay towards creditors in a converted Chapter 13 case that would provide no return to general unsecured creditors. However, the numbers belie the Debtors’ contention.

First, the court looks at the significant deduction that the Debtors take on their Schedule I for retirement contributions even though the Debtors were making no such contributions at the time of the bankruptcy filing. Debtors assert that BAPCPA’s changes to the Bankruptcy Code provide protective treatment to ongoing voluntary retirement contributions in Chapter 13 cases making the contributions an appropriate deduction on their schedules.

To some extent, the Debtors are correct. By excluding certain contributions to retirement plans from "property of the estate" and "disposable income" in 11 U.S.C. § 541(b)(7), Congress implemented a policy of encouraging retirement savings and protecting those savings from creditors. *See Phillips,* 417 B.R. at 41. Furthermore, this court has held that it would consider the favorable treatment of retirement contributions in Chapter 13 cases when conducting its analysis of abuse pursuant to § 707(b). *Id.* at 41-43.

However, not all retirement contributions receive such favorable treatment and that point is highlighted in the recent decision from the Bankruptcy Appellate Panel for the Sixth Circuit ("BAP"), *Burden v. Seafort (In re Seafort)*, 437 B.R. 204 (B.A.P. 6th Cir. 2010).

In *Seafort,* a consolidated appeal involving two separate sets of debtors, the Chapter 13 debtors were repaying 401(k) loans, but were not making any additional contributions to retirement plans at the time they filed their separate bankruptcy petitions. 437 B.R. at 206. The debtors proposed five year Chapter 13 plans that would fully repay their respective 401(k) loans before completion of the plans. *Id.* Once the loans were paid off, however, the debtors did not propose to increase payments to unsecured creditors with the funds freed up following repayment. *Id.* Instead, the debtors proposed to continue the same payroll deductions and allocate the funds towards new post-petition 401(k) contributions. *Id.* The Chapter 13 trustee objected to confirmation arguing that the debtors were not entitled to make retirement contributions post-petition unless they had been making ongoing contributions at the time they filed their respective bankruptcy petitions. *Id.* The trustee asserted that the debtors must, instead, increase plan payments to unsecured creditors once their retirement loans were paid off. *Id.* at 206-07.

Agreeing with the trustee's argument, the BAP concluded that only 401(k) contributions that were being made at the commencement of the case were excluded from the definition of property of the estate and disposable income pursuant to 11 U.S.C. § 541(b)(7). *Id.* at 209-10. In making this determination, the BAP took special note of the delicate balance Congress struck between protecting retirement and requiring debtors to pay their creditors:

> This balance is best achieved by permitting debtors who are making contributions to [retirement] at the time their case is filed to continue making contributions, while requiring debtors who are not making contributions at the time a case is filed to commit post-petition income which becomes available to the repayment of creditors rather than their own retirement plan. To conclude otherwise encourages the improvident behavior that BAPCPA sought to discourage. If the bankruptcy court is affirmed, debtors who were not contributing to their tax qualified plan and borrowing against their own retirement savings may file bankruptcy, repay themselves, and, once the loan is repaid, start contributing again to their own retirement savings. Allowing debtors to do so would tip the delicate balance struck by BAPCPA impermissibly in favor of debtors. On the other hand, allowing debtors who are making contributions at the commencement of a case to continue making those contributions furthers the goal of encouraging retirement savings. Limiting these protections to contributions in place at the time debtors file their petitions also protects the goal of ensuring that debtors pay creditors the maximum amount debtors can afford to pay.

Seafort, 437 B.R. at 210. The *Seafort* decision makes clear that if 401(k) contributions were not being made by a debtor as of the commencement of the case, then the funds must be directed to creditors in a Chapter 13 plan. *Id.*[7] Accordingly, such funds must also be considered money available to creditors when conducting a § 707(b) analysis.

In this case, the Debtors have not contributed to Jay Harris's 401(k) plan since January of 2010 and were not making contributions at the time of their July 30, 2010 bankruptcy filing. Pursuant to *Seafort,* the Debtors would not be able to initiate contributions to a 401(k) in a converted Chapter 13 case. Consequently, these funds must be considered projected disposable income available to creditors.[8]

When the Debtors' proposed monthly 401(k) contribution of $1,332.50 is added back into their monthly projected disposable income,[9] the Debtors have $2,859.33 each month to pay towards a Chapter 13 plan or a total of $171,559.80 to devote to a plan over five years. Although the Debtors' plan payments must first pay attorney fees, the Chapter 13 Trustee's administrative fee[10] and significant priority and secured tax debts,[11] the court calculates that unsecured creditors still stand to recover approximately 48% on their claims, a far better outcome for these creditors than the 0% recovery they face in a

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[7] As of the writing of this decision, *Seafort* is on appeal to the Sixth Circuit Court of Appeals, but no determination has been made. Accordingly, the court looks to the BAP's *Seafort* decision as precedent. *See Weidle Corp. v. Leist (In re Leist),* 398 B.R. 595, 606 n.11 (Bankr. S.D. Ohio 2008); *Rhiel v. OhioHealth Corp. (In re Hunter),* 380 B.R. 753, 772-75 (Bankr. S.D. Ohio 2008) (discussing the need for bankruptcy courts to follow decisions of their Circuit's bankruptcy appellate panel).

[8] The Debtors argue that they could easily dismiss their case, begin making 401(k) contributions, and then file a new Chapter 13 case to subvert the BAP's holding in *Seafort*. While this may be true, for purposes of making a § 707(b) determination, the court must look at the factual circumstances of the Debtors at the time of the hearing rather than consider the speculative terms of a new case filed at an undetermined future date in which the Debtors' circumstances may be different.

[9] Prior to adding back in the retirement contributions, the court calculated the Debtors' monthly projected disposable income to be $1,526.83. Although this number is slightly different from that calculated by the Debtors or the UST, it is the number which best comports with the testimony at the hearing and the analysis by the parties in their post-hearing briefs.

[10] The fee was calculated at 4.6% of net monthly projected disposable income.

[11] As noted in the fact section, the court calculates the Debtors' priority and secured tax debts to total $81,892.40, an amount which includes their potential personal liability for the $37,088.40 in business related tax debt that was discovered after the bankruptcy filing.

liquidation situation. Indeed, courts have found "abuse" pursuant to § 707(b) even when calculating a much lesser potential return to creditors in a hypothetical Chapter 13 analysis. *See Behlke*, 358 F.3d at 437-38 (concluding that a Chapter 7 case constituted a substantial abuse when debtors could pay between 14% and 23% of their unsecured debts in a Chapter 13 case); *In re Mestemaker*, 359 B.R. 849, 857 (Bankr. N.D. Ohio 2007) (finding an abuse when a debtor could pay 10% to 15% of all unsecured debt in a Chapter 13 case). Given the potential for a significant distribution to creditors within the context of a Chapter 13 reorganization, the court concludes that it would be an abuse to allow these Debtors to remain in Chapter 7.

CONCLUSION

The Debtors have significant income allowing them to pay their unsecured creditors a meaningful distribution within the context of a Chapter 13 plan of reorganization or outside of bankruptcy. Consequently, their continued pursuit of relief under Chapter 7 constitutes an abuse pursuant to 11 U.S.C. § 707(b)(3). Accordingly, the Debtors' case will be dismissed unless the Debtors elect to convert their case to one under Chapter 13 within thirty (30) days of the date of the entry of this decision and the corresponding order.

Should the Debtors choose conversion, the court recognizes the potential for some unresolved issues to impact the overall return to unsecured creditors either positively or negatively. These issues include: 1) whether the Debtors will need newer vehicles in the near future; 2) whether the Debtors may submit additional funds towards their student loan creditor; 3) whether other expenses listed by the Debtors in their budget, such as life insurance and a YMCA membership, are appropriate; 4) the impact of Mrs. Harris's election not to work given her education and skills; and 5) the final computation of the Debtors' personal liability to the IRS for taxes. The court believes that these issues should be evaluated by the Chapter 13 Trustee and creditors within the context of an actual Chapter 13 case and are not necessary for determination by the court at this time.

SO ORDERED.

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